

CITIES SERVICE OIL AND GAS CORP.

IBLA 87-752

Decided March 9, 1990

Appeal from a decision of the Director, Minerals Management Service, affirming an order of the Regional Manager, Tulsa Regional Compliance Office, Royalty Management Program, assessing additional royalties on natural gas liquid products. MMS-86-0201-OCS.

Affirmed as modified.

1. Administrative Procedure: Rulemaking--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

The Procedure Paper on Natural Gas Liquid Products Valuation, developed by MMS, is not a substantive regulation subject to the rulemaking requirements of the Administrative Procedure Act, 5 U.S.C. § 553(b) (1982).

2. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Since, unless otherwise expressly provided, all royalty payments are accepted subject to audit, a subsequent determination that additional royalties are due does not give rise to a question of retroactive application of a new rule if the determination that a deficiency exists was made under the regulation applicable at the time that the payment was originally made.

3. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Oil and Gas Leases: Royalties: Payments--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where a floor price was established generally for natural gas liquid product valuation for royalty calculation, royalty could not be assessed using a higher rate than the floor price.

APPEARANCES: Patricia A. Patten, Esq., Tulsa, Oklahoma, for appellant; Peter J. Schaumberg, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

## OPINION BY ADMINISTRATIVE JUDGE BURSKI

Cities Service Oil and Gas Corporation (Cities Service) has appealed from a decision of the Director of the Minerals Management Service (MMS), dated June 29, 1987, affirming an order of the Regional Manager, Tulsa Regional Compliance Office (TRCO), Royalty Management Program, assessing additional royalties in the sum of \$23,904.83 on Cities Service's share of natural gas liquid products (NGLP's) processed at the Grand Chenier Processing Plant (Grand Chenier) from 22 Outer Continental Shelf (OCS) leases. <sup>1/</sup> The additional royalties were assessed as a result of a determination that Cities Service had undervalued NGLP production during the period January 1980 through April 1983.

NGLP's are produced by Cities Service from the subject Federal offshore leases and processed at Grand Chenier. Grand Chenier is operated by Conoco Inc. (Conoco), on behalf of itself and nine other major owners, including Cities Service. At all pertinent times, Conoco paid royalties for Cities Service's share of NGLP's processed at Grand Chenier.

In February 1984, an audit conducted by the Office of Inspector General concluded that, for the period from January 1977 through December 1982, a total of \$1,801,700 in additional royalties were owed by seven oil companies on NGLP's processed at the Grand Chenier processing plant. The results of this audit were submitted to the Assistant Secretary, Land and Minerals Management. Thereafter, MMS conducted its own review of royalty computations and payments produced from Federal leases and processed at the Grand Chenier plant. By letter dated March 31, 1986, the Regional Manager, TRCO, informed Conoco, with a copy to Cities Service, that the review indicated that Conoco had underpaid royalties on Cities Service's share of NGLP's for the period between January 1980 through April 1983 in the amount of \$23,904.83.

In explaining the basis for his conclusion that Cities Service had underpaid royalties on the NGLP's, the Regional Manager noted that, pursuant to the "Procedure Paper on Natural Gas Liquid Products Valuation" (Procedure Paper), which had been developed by MMS, if NGLP's are disposed of by non-arm's-length transactions, including transfers to affiliates, the unit values will be compared to the lowest price published in commercial bulletins. If the unit price falls below the low price, it would be considered unreasonable and an average price would be calculated for use in determining the amount of royalties owed. The Regional Manager noted that Cities Service had used most of its own NGLP production internally, utilizing a Mont Belvieu spot price less a transportation differential to value its production. The Regional Manager determined that, in those instances in

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<sup>1/</sup> The leases involved are: OCS-0160, OCS-0161, OCS-0163, OCS-0184, OCS-0187, OCS-0190, OCS-0191, OCS-0764, OCS-0766, OCS-0767, OCS-0768, OCS-G-0932, OCS-G-0934, OCS-G-1470, OCS-G-1471, OCS-G-2126, OCS-G-2127, OCS-G-3293, OCS-G-3294, OCS-G-2857, and OCS-G-3269.

which Cities Service's values were less than the lowest Mont Belvieu spot price, it was properly required to pay additional royalties based on the calculated average value for the same period, which resulted in additional royalties in the amount requested.

Cities Service appealed this determination to the Director, MMS. In its appeal to the Director, Cities Service argued, inter alia, that the Procedure Paper constituted a regulation which had not been published as required by the Administrative Procedure Act (APA), 5 U.S.C. § 553 (1982), and that the retroactive application of policies enunciated in the Procedure Paper constituted a departure from prior Departmental practices upon which Cities Service had relied. Further, Cities Service argued that, even ignoring its allegation that the Procedure Paper had been invalidly promulgated, the Regional Director had incorrectly applied the procedures delineated therein since, if it had been provided the opportunity, Cities Service would have demonstrated that its non-arm's-length contract had characteristics similar to arm's-length contracts and, thus, the price which it received represented fair market value.

Cities Service also argued that the Regional Manager had, in effect, penalized Cities Service when its prices fell below the "yardstick" value but granted it no countervailing credit when its prices exceeded that value. Finally, Cities Service argued that the Regional Manager failed to consider all of the costs of marketing NGLP's and, therefore, his decision did not accurately reflect their market value at the plant tailgate. By decision dated June 29, 1987, the Director, MMS, rejected all of these arguments and affirmed the determination of the Regional Manager, TRCO, that Cities Service owed \$23,904.83 in additional royalties. An appeal to this Board followed.

On appeal to this Board, Cities Service reiterates three of the arguments which it made before the Director, MMS. First, it argues that MMS is applying the Procedure Paper as a rule of law rather than as a policy paper and that, as such, its promulgation violated relevant portions of the APA. Next, it argues that MMS should be estopped from applying the Procedure Paper retroactively to Cities Service's detriment. Finally, appellant argues that MMS failed to recognize Cities Service's arm's-length contract, as provided for in the Procedure Paper.

At the outset, it is useful to describe the relevant portions of the Procedure Paper. As indicated above, the Procedure Paper is designed to assure that proper royalties are tendered on NGLP production. To effectuate this intent, the Procedure Paper set out to develop what it referred to as a "'yardstick' valuation technique" (Procedure Paper at 3). The Procedure Paper noted that a review of various factors such as the NGLP sales contracts, prices received by lessees, Table 7 Department of Energy (DOE) prices, and commercially available NGLP bulletins, had led to the conclusion that the price bulletins represented the best available price source and would, in most instances, be indicative of NGLP fair market value (Procedure

Paper at 5). Accordingly, use of three bulletins was recommended. <sup>2/</sup> The "yardstick" price was to be derived by using the highest and lowest prices for each month from the appropriate bulletin. Any reported value falling within this range would be within the "yardstick" valuation. If the reported value was below the range of values for a specific month, the average value of the "yardstick" for that month would be the minimum value accepted by MMS (Procedure Paper at 6-7).

The "yardstick" value was not automatically applied, however. Thus, MMS recognized that where arm's-length contracts <sup>3/</sup> existed the contract price would normally be considered to establish fair market value for royalty purposes unless the gross proceeds actually received were higher than the contract price. Moreover, since NGLP prices had been controlled by DOE regulations until January 1980 (February 1981 for propane), MMS realized that it was necessary to differentiate between the period of price control and price decontrol. Thus, the Procedure Paper provided that if, during the control period, a lessee received a maximum permissible price under the DOE regulations, this price would be accepted as fair market value, even if it were less than the price called for in a sales contract.

The "yardstick" valuation only came into play in those situations where a sales contract was a non-arm's-length contract or if no contract existed at all. Even in this situation, the Procedure Paper provided that if a non-arm's-length contract existed "and the lessee can demonstrate that the contract has characteristics similar to arm's-length contracts which represent fair market value, MMS will accept the non-arm's-length contract price for royalty computation purposes" (Procedure Paper at 9). However, in those situations in which either no contract existed or where a lessee was unable to show that its non-arm's-length contract had the indicia of an arm's-length contract, the "yardstick" price would be used to establish fair market value unless, in the period of controlled prices, the maximum permissible price was below the "yardstick" value. Since the instant case involved royalty valuations after the period of control and because MMS found that there was no arm's-length contract for the sale of the NGLP's, MMS used the "yardstick" price to determine the acceptability of the value on which Cities Service was computing royalty and, where the price fell below the "yardstick" range, required Cities Service to tender royalties on the "yardstick" average.

[1] As we noted above, appellant attacks MMS' use of the Procedure Paper as "an effort by the MMS to promulgate rulemaking," which effort,

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<sup>2/</sup> While not directly relevant to any of our present concerns, the Procedure Paper established a hierarchy among the three bulletins, dependent upon their availability for the specific period in question.

<sup>3/</sup> An "arm's-length contract" was defined in the Procedure Paper as "a contract or agreement that was freely arrived at in the open market place between independent, non-affiliated parties of adverse economic interests. The contract did not involve any considerations other than the sale of NGLP's and was prudently negotiated under the facts and circumstances existing at the time" (Procedure Paper at 4).

appellant assets, must fall because of the failure of MMS to follow the rulemaking procedures set forth at 5 U.S.C. § 553 (1982). Critical to this argument is the contention that the Procedure Paper contradicts the applicable regulations governing computation of value for royalty purposes and that, therefore, the Procedure Paper constitutes a substantive rule supplanting an existing regulation rather than an interpretation of an existing rule.

The Board has examined this question numerous times in recent decisions and has consistently found that the Procedure Paper is not a rule of law (i.e., a substantive rule) superseding an existing rule, but rather merely establishes internal guidelines for applying existing regulations, particularly 30 CFR 206.150 (1987). <sup>4/</sup> Thus, in Amoco Production Co., 112 IBLA 77 (1989), in responding to a similar challenge we noted:

Appellant has failed to establish that MMS abandoned the relevant regulation in favor of the Procedure Paper. In fact, the Procedure Paper itself relies on the factors set forth in the regulation--the lessee's price, regulated prices, posted prices, and gross proceeds. It provides guidance by specifying which of the factors listed in 30 CFR 250.64 (1982) is to be given the most weight in various circumstances.

Id. at 81. Then, after describing the approach limned by the Procedure Paper, we quoted from Conoco Inc., 110 IBLA 232, 242-43 (1989):

The Procedure Paper merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees. It did not require lessees to value their production by any specific method, nor did it modify any existing regulation. Rather, it found that, after consideration of the factors listed in the regulations, the best measurement of the reasonable value of NGLP in situations where no arm's-length contract existed was the commercially available spot price bulletins. We find the Procedure Paper to be essentially a policy guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation. As

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<sup>4/</sup> That regulation provided:

"The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary."

such, it does not have the force and effect of law as a duly promulgated regulation does, and the Board will decline to follow it where it is inconsistent with the terms of the relevant regulations.

Id. at 82. We adhere to our consistent holding that the Procedure Paper merely establishes internal guidelines to be used in implementing the relevant regulatory and statutory mandates and reject appellant's assertion that it is a rule of law which was not properly adopted under the provisions of the APA.

[2] Appellant also argues that the Procedure Paper cannot be applied retroactively to appellant's detriment. The premise of Cities Service's argument appears to be based on its prior assertion that the procedures enunciated in the Procedure Paper were in conflict with the applicable regulations. Inasmuch as we have already rejected that contention, Cities Service's argument on retroactivity must similarly be rejected.

Moreover, to the extent that appellant is contending that, having originally accepted its payments, MMS can no longer challenge the basis upon which they were computed, appellant is simply wrong. As the Board has long noted, in the absence of an express statement to the contrary, all royalty payments are accepted subject to audit and "the silent acceptance of royalty when initially tendered does not constitute an express determination of the proper royalty level." Supron Energy Corp., 55 IBLA 318, 321 (1981). Accord Big Piney Oil & Gas Co., A-29895 (July 27, 1964). Appellant was clearly aware that all of its royalty payments were subject to look-back audits and MMS cannot be estopped by the mere acceptance of such payments from demanding additional royalties based on a finding that the prices upon which these royalties were computed did not constitute fair market value. See Supron Energy Corp., 46 IBLA 181, 189-92 (1980).

Nothing in Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950), compels a contrary conclusion. In that case, the Department had formally adopted a valuation of natural gas in 1931 which it then altered in 1937. In Continental, the Court, in response to an attempt by the Department to assert authority to retroactively apply this new rule to production prior to 1936, affirmed the implicit finding of the District Court below (United States v. General Petroleum Corp., 73 F. Supp. 225, 256 (S.D. Cal. 1947)) that the 1937 valuation formula could only be applied prospectively. The point which the District Court was making, however, is that the Secretary, having made the election to value gas under one method in 1931, was bound by that election until such time as it was formally revised in 1937. But, as noted above, no such election was ever made herein. Indeed, the substance of the regulations remained constant throughout the period in question.

What appellant essentially asserts is that it tendered royalty to the United States under appellant's valuation and the United States should be barred from thereafter challenging the amount tendered. This precise argument was rejected in Supron Energy Corp., 46 IBLA 181 (1980):

The Ninth Circuit's rule in Continental is consistent with that in Big Piney, *supra*: Where the Department has not specified that a particular method of valuation adopted by a lessee is adequate, it may assert that the method is incorrect and redetermine royalty after the sales, even though payment has already been accepted (Big Piney); where the Department has specified that a method of valuation is adequate, it may not assert that this method is incorrect or incomplete and reassess value retroactively in order to raise the royalty due, even though payments have not been tendered (Continental). [Emphasis in original.]

Id. at 191.

In the instant case, MMS is attempting to fulfill its statutory man-date to make sure that the United States receives the royalty due and owing to it. In order to accomplish this charge, MMS adopted the Procedure Paper as a guideline by which it might determine whether the payments submitted by lessees represented a fair return to the Government. In so proceeding, MMS was acting under authority delegated by the Secretary and reserved by the express terms of both the regulations and the leases to determine the fair market value to be used in royalty computations. See 30 CFR 206.150 and section 3(a)(2) of the standard lease form. The concern that the Government and the citizens of the United States obtain fair return on national resources cannot be said to be minor or trifling.

Opposing this consideration is the necessity to assure that the Government fairly treat all those who deal with it. Thus, while it has been noted that those who deal with the Government "must turn square corners" (Rock Island, Arkansas & Louisiana R.R. v. United States, 254 U.S. 141, 143 (1920)), it has also been remarked that "[i]t is no less good morals and good law that the Government should turn square corners with the people." St. Regis Paper Co. v. United States, 368 U.S. 208, 229 (1961) (Black, J., dissenting). The problem for appellant, however, is that the requirement that it tender royalty on fair market value of the NGLP's which it produces has always been in existence. The regulation on which such a determination was to be made stayed the same. The factors to be considered remained constant. If, in point of fact, the Procedure Paper has devised a tech-nique which correctly ascertains fair market value in accordance with the statute and regulations, appellant has no cause for complaint based on considerations of retroactivity since appellant has always been required to tender royalty on that basis. In other words, where Government acceptance of the tender of royalties is made subject to post audit, the mere recomputation of royalty payments due to the Government to correctly reflect fair market value of NGLP's does not constitute imposition of a penalty or give rise to an issue of retroactive application of a new rule. 5/

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5/ This case is readily distinguishable from our recent decision in Sun Exploration & Production Co., 112 IBLA 373 (1990). That decision involved computation of sliding-scale royalty where part of the production had been

Finally, appellant argues that "MMS has failed to recognize Cities Service's arm's length contract" (SOR at 15). In support of this contention, appellant asserts:

The MMS has defined the entire period of the audit assessment as based on interaffiliate transfers, therefore justifying the yardstick valuation. During the 1982-83 period, interaf-filiate sales were less than 2/10 of 1 percent of total Gulf Coast propane sales and should not have been subject to the yardstick rule. Except for February, 1983, no Cities Service propane values were below the lowest Mont Belvieu posting per the BPN Newsletter. Additionally, Cities has purchased Sohio Petroleum Company's, Newmont's, and Exxon's product for a number of years at the same price or less as reported to Conoco for settlement purposes. (See Exhibit "C".)

(SOR at 15).

In response, MMS points out that there is no evidence in the record that Cities Service's contracts bore the indicia of an arm's-length-contract, noting that while appellant had purportedly submitted Exhibit C to support this allegation, no Exhibit C was, in fact, attached to the filing. We agree that Cities Service has completely failed to substantiate its contention that its non-arm's-length contracts should have been treated as arm's-length contracts because of similar characteristics with such contracts.

Appellant had made this same argument before the Director, MMS. In rejecting its assertions, the Director noted:

While Cities alleges that it has had no opportunity to demonstrate that its non-arm's-length contracts represent fair market value, Cities received a copy of a tentative underpayment determination and in response submitted additional information. No reason appears why Cities did not avail itself of this opportunity to submit evidence that its non-arm's-length contracts represented fair market value. Similarly such evidence could have been submitted along with Cities' Supplemental Statement

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fn. 5/ continued

used in lease operation. In Sun, not only was there a prior established method for making this computation set forth in the Conservation Division Manual, but appellant had actually been directed to conform its reports to this prior method. Accordingly, the Board held that the new computation method could only be applied prospectively. Id. at 388-91.

The Sun decision is, thus, in accord with the approach delineated in Supron Energy Corp., 46 IBLA 181 (1980), discussed supra. In contrast to the situation in Sun, the instant appeal does not involve a prior method of valuation adopted by the Department but merely a valuation method utilized by appellant which it desires to have the United States ratify. We decline to do so.



of Reasons in support of the appeal. Again, no explanation was offered why such evidence was not introduced.

(Decision at 6).

It is clear that appellant has had ample opportunity to attempt to establish that its non-arm's-length contracts had, in the words of the Procedure Paper, "characteristics similar to arm's-length-contracts which represent fair market value" (Procedure Paper at 9). Even at this late date, it has failed to make even a minimal evidentiary showing supportive of its assertions. <sup>6/</sup> Its conclusory allegation of error can be accorded no weight.

[3] While we have rejected all of the challenges which appellant has brought against the decision of the Director, MMS, it is, nevertheless, necessary for the Board to modify the decision below in one important aspect. Thus, as we noted earlier, in those situations in which the "yard-stick" valuation applied and a monthly reported value fell below the "yardstick" range, the average value of the "yardstick" for that month would be the minimum value accepted by MMS. In Conoco Inc., supra, we rejected this aspect of the Procedure Paper, noting that since the lowest price established a floor price for royalty valuation and such price must itself constitute fair market value in order for it to be acceptable, the floor price rather than the average value of the "yardstick" should be used to recompute the royalty due to the United States. 110 IBLA at 244. See also Cities Service Oil & Gas Corp., 112 IBLA 89 (1989); Union Oil Co., 111 IBLA 369 (1989). We hereby modify the decision below to conform to this holding. Accordingly, while we reject appellant's objections to the decision under appeal, it will be necessary, upon remand of this case, for MMS to recompute the amount due to reflect the floor rather than the average "yardstick" price.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed as modified and the case file is remanded for recomputation of the amount of additional royalty due the United States.

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James L. Burski  
Administrative Judge

I concur:

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Will A. Irwin  
Administrative Judge

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<sup>6/</sup> Thus, despite the fact that MMS expressly alluded to the failure of appellant's submissions to include "Exhibit C," appellant never sought to rectify or explain this omission.